



November 19, 2004

Tax Benefit Granted to Wrongful Discrimination Plaintiffs

In the recently-enacted American Jobs Creation Act of 2004 (P.L.108-357), a new subsection was added to the Internal Revenue Code for the purpose of ensuring that plaintiffs who win awards or settlements in certain civil rights cases and other lawsuits do not pay income tax on the part of the recovery paid to attorneys.

The new legislation provides an "above-the-line" deduction (instead of a "miscellaneous deduction") for attorneys' fees and costs paid by a plaintiff in connection with any action involving a claim of unlawful discrimination, including age discrimination, certain claims against the Federal Government, or a private cause of action under the Medicare Secondary Payer statute. The effect of this provision is that plaintiffs involved in these claims will be able to offset the legal fees against the total recovery, and will be taxed only on the net recovery – thereby avoiding the limitations otherwise imposed on miscellaneous itemized deductions. The provision also allows for a full deduction of such expenses and costs for purposes of the alternative minimum tax (AMT).

What does this mean to you? It means that you can expect plaintiffs' claims to be framed as being one of the described types so as to ensure that the plaintiffs can take advantage of this new tax rule.

What this new provision doesn't do, however, is change the taxability of the payments made to the plaintiffs. Nor does it change your withholding and reporting obligations with respect to such payments – those obligations remain the same as before. For example, if an employer settles a claim for back wages by issuing a check payable jointly to both the employee and his or her attorney, and delivers the check to the attorney, as under prior law the employer is required to issue a Form 1099 to the attorney for the amount of the check (net of income and FICA tax withholding) and is also required to issue a Form W-2 to the employee for the gross settlement amount.

For more information about this issue, please contact a member of the Labor and Employment Practice Group in one of our offices.

Los Angeles	San Diego	San Francisco
Charles F. Barker (213) 617.4168	David B. Chidlaw (619) 338.6614	Douglas J. Farmer (415) 774.2906
Elicia N. Bernstein (213) 617.5582	John D. Collins (619) 338.6613	Lara V. Hutner (415) 774.2903
Geoffrey D. DeBoskey (213) 617.5547	Julie A. Dunne (619) 338.6510	Otis McGee, Jr. (415) 774.3249
David J. Fishman (213) 617.4118	Guy N. Halgren (619) 338.6605	Michael Scarborough (415) 774.2963
Jason R. Gasper (213) 617.5499	Samantha D. Hardy (619) 338.6640	
Adena Hadar (213) 617.4128	Stacey E. James (619) 338.6581	Del Mar Heights
Douglas R. Hart (213) 617.5497	Rafael Nendel-Flores (619) 338.6619	Richard M. Freeman (858) 720.8909
Derek R. Havel (213) 617.5424	A. Andrew Peterson (619) 338.6624	Matthew McConnell (858) 720.8928
Kelly L. Hensley (213) 617.5441	Kim Snyder (619) 338.6506	Carole M. Ross (858) 720.8925
Melissa Hughes (213) 616.5464	Mary P. Snyder (619) 338.6503	
Tracey A. Kennedy (213) 617.4249	William V. Whelan (619) 338.6588	Santa Barbara
Melissa P. Lopez (213) 617.4290	Tara L. Wilcox (619) 338.6608	Jeffrey Dinkin (805) 879.1828
Richard L. Lotts (213) 617.4119		Deborah Martin (805) 879.1838
Daniel J. McQueen (213) 617.4270	Orange County	
Kristine A. Moon (213) 617.5523	Heather Clark (714) 424.2820	Washington, D.C.
Jocelyn Riedl (213) 617.5592	Greg S. Labate (714) 424.2823	Mark E. Nagle (202) 218.0014
Richard J. Simmons (213) 617.5518	Mary E. Lynch (714) 424.2826	Julia H. Perkins (202) 772.5316
Dianne Baquet Smith (213) 617.4265	Ryan D. McCortney (714) 424.2830	Mary E. Pivec (202) 772.5310
Beth S. Sonnenklar (213) 617.4187		
Brandyn Stedfield (213) 617.5514		
Natalie C. Trask (213) 617.4229		
Jennifer B. Zargarof (213) 617.4243		

SHEPPARD, MULLIN, RICHTER & HAMPTON LLP				
LOS ANGELES 213 · 620 · 1780	CENTURY CITY 310 · 228 · 3700	SAN FRANCISCO 415 · 434 · 9100	ORANGE COUNTY 714 · 513 · 5100	
DEL MAR HEIGHTS 213 · 620 · 1780	SAN DIEGO 619 · 338 · 6500	SANTA BARBARA 805 · 568 · 1151	NEW YORK 212 · 332 · 3800	WASHINGTON, D.C. 202 · 218 · 0000
www.sheppardmullin.com				